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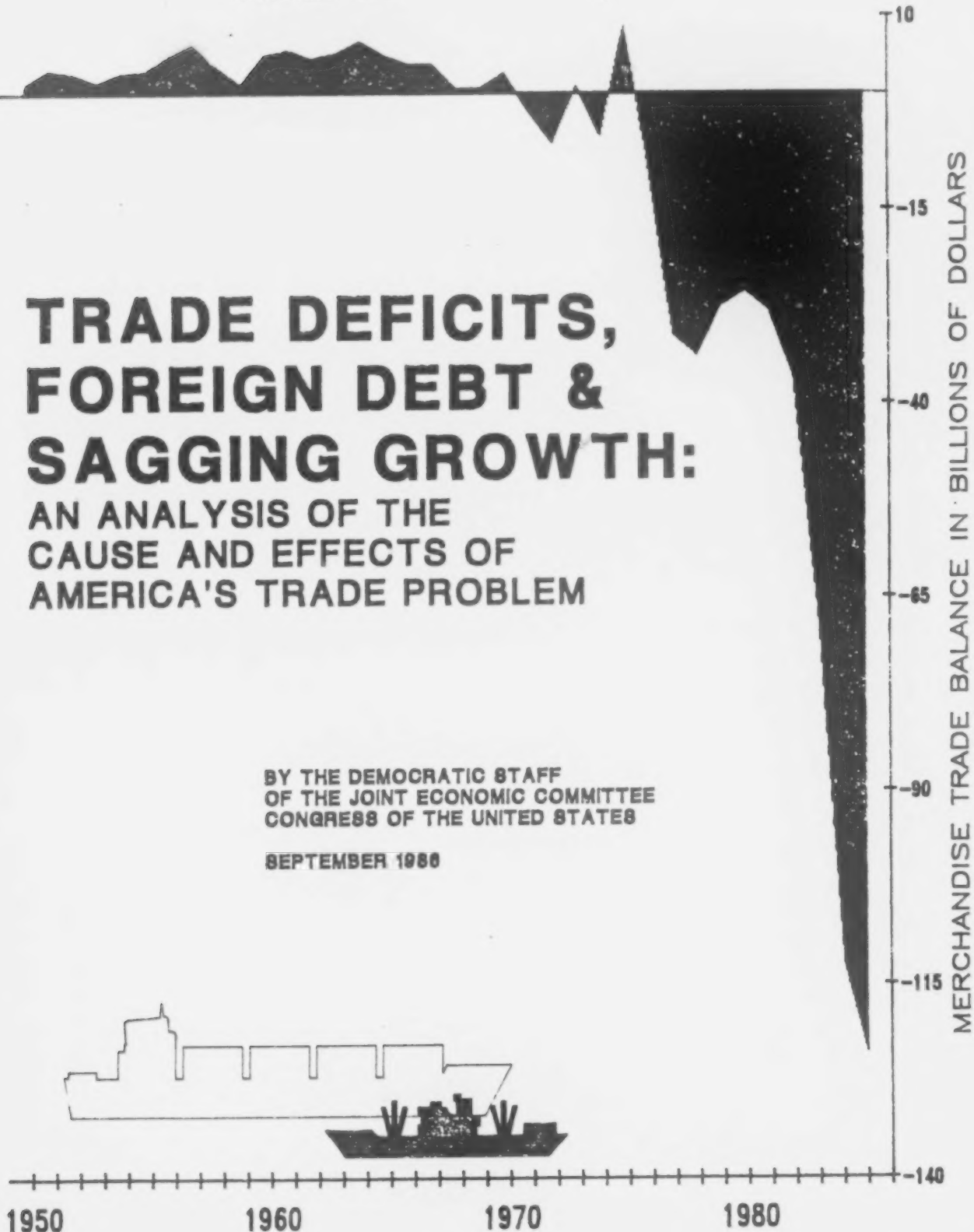
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TRADE DEFICITS, FOREIGN DEBT & SAGGING GROWTH:

AN ANALYSIS OF THE
CAUSE AND EFFECTS OF
AMERICA'S TRADE PROBLEM

BY THE DEMOCRATIC STAFF
OF THE JOINT ECONOMIC COMMITTEE
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The 1980s have been a time of significant progress for the United States in its battle against inflation and its efforts to create new jobs. Unfortunately, there are a number of factors in addition to inflation and job growth that determine the economic well-being of a nation and many of those factors turned decidedly negative during the current decade.

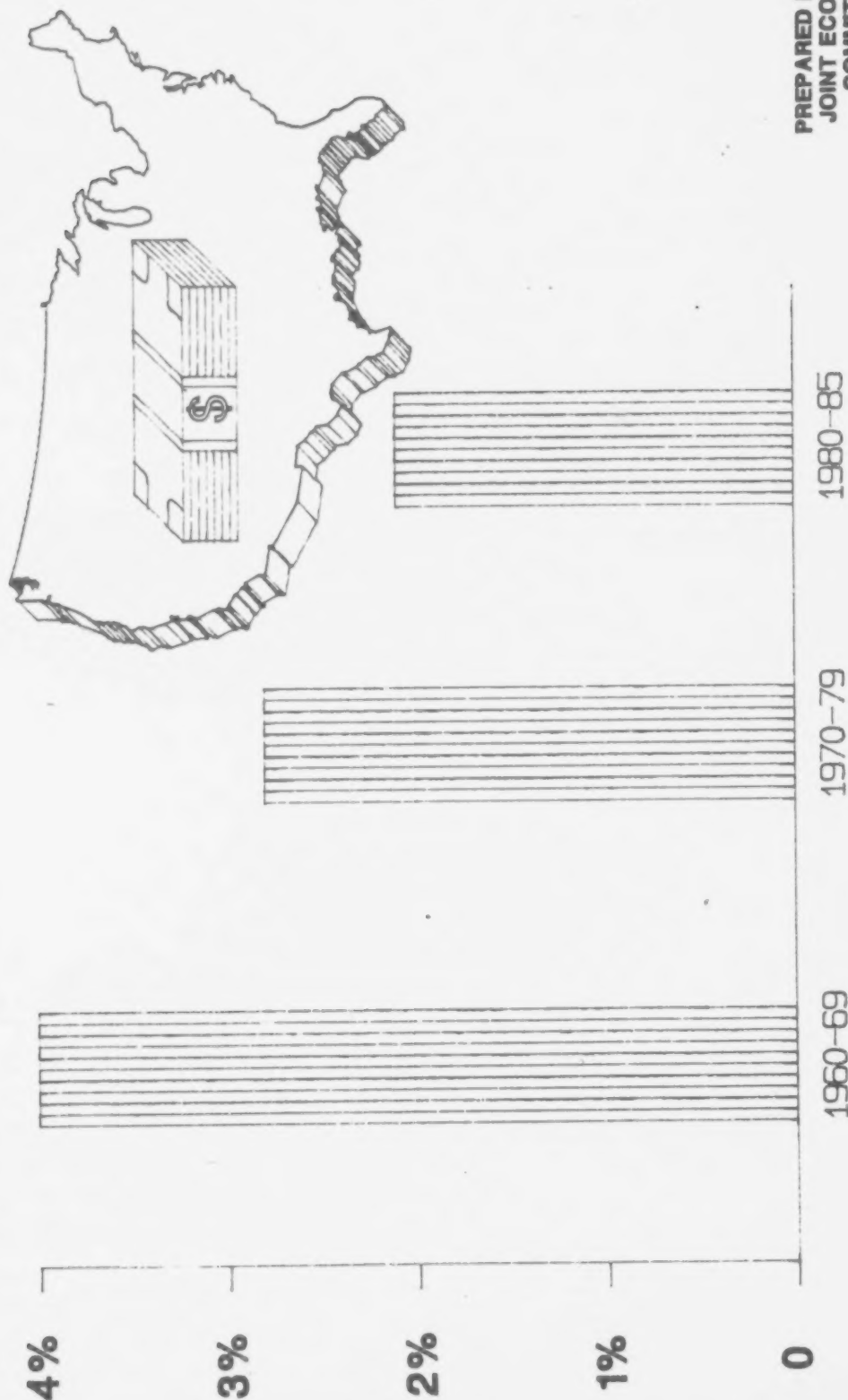
Thus far, the 1980s have been a period of declining real wages, sagging family income, record numbers of farm and small business bankruptcies (for the post-war era), and major declines in plant utilization and manufacturing employment. Unemployment rates have also remained consistently above the levels associated with recessions in the 1950s, 1960s and 1970s.

Similarly, the growth of real Gross National Product, often considered the most important index of overall economic well-being, has not only fallen below the record-setting pace of the 1960s, but lags far behind the disappointing performance of the 1970s as well (Chart 1). However, the most disturbing omen for future growth during the remainder of the 1980s and beyond has been the rapid deterioration of the nation's position in world trade accompanied by the rapid accumulation of the nation's external debt.

CHART 1

THE DECLINE IN GNP GROWTH

AVERAGE ANNUAL GROWTH RATES IN PERCENT



PREPARED BY THE
JOINT ECONOMIC
COMMITTEE

This paper contends that the growth of the trade deficit is the primary factor behind the nation's poor rate of overall economic growth during this decade. It further contends that a central factor in that decline has been the reversal of the U.S. trade position in Latin America. Most importantly, the paper contends that Latin America--and not Japan and West Germany--is the most significant potential source of expanded demand for American products and is, therefore, central to avoiding a worldwide recession caused by inadequate demand.

I. A DECADE OF SLOW GROWTH?

In the three and one-third decades between 1947 and 1980, the U.S. economy grew at a 3.3% annual average rate. During the past five and one-half years, however, the pace of real GNP growth dropped below its historical average. The 2.1% annual rate of real GNP growth between 1981 and the first half of 1986 compares unfavorably to the 1970s when real economic growth averaged 2.8% or the 1960s when real GNP advanced at a 3.8% average annual rate.^{1/}

Many economists believe that the current bout of anemic GNP growth is a symptom of a more deep-seated problem--the rapidly increasing U.S. trade deficit. For example, in comparing the most recent economic recovery with previous post-war recoveries, administration economists earlier this year noted that real exports of goods and services typically expand at an 8.8% annual rate during a recovery's first three years. During the first three years of this recovery, however, real exports grew at a

below par 2.4% annual pace. Similarly, real imports increased at an 8.6% average annual rate during previous post-war recoveries. But in this recovery, real imports surged at a 14.6% annual rate.^{2/}

The implication of these statistics is clear: during this recovery, sales of foreign products in U.S. markets were growing at nearly twice their historic rate. Simultaneously, sales of U.S. products to overseas customers were rising at only one-third their usual rate. The result is an exploding trade deficit that, according to many economists, is sapping vitality from the U.S. economy.

For example, in their recent report, U.S. Trade Deficit at a Turning Point, the National Association of Manufacturers termed the growing merchandise trade deficit "a chronic drag on U.S. domestic growth and employment."^{3/} And in his testimony before the Senate Banking Committee this past July, Federal Reserve Board Chairman Paul Volcker went to great lengths to explain how an increasing trade deficit slows the economy, declaring:

For more than a year, industrial production in the United States has not grown appreciably, and there has been some decline in 1986. The pace of business investment has slackened....A large part of the difficulty stems from the continuing imbalances in the world economy....The plain implication is that our overall GNP growth rate was reduced by continuing deterioration in our trade and current account balances. With our current account deficit reaching a record \$135 billion annual rate in the first quarter of this year, industrial production and investment were restrained.^{4/}

Perhaps more important than the damage that has already been done to the economy is the fact that without an immediate improvement on the trade front, there is little chance that the damage will be repaired and economic growth will accelerate, as many forecasters are predicting. For example, in announcing the

Fed's economic growth projections for the remainder of 1986 and 1987, Volcker reported that the Board of Governors was forecasting real economic growth of between 3% and 3.5 percent. But he cautioned that achieving even this modest rate of advance was contingent upon "the potential contribution to that growth of a stronger trade balance."

The Congressional Budget Office reports that its recent forecast of 3.5% economic growth in 1987 is also based on the assumption that there will be a substantial reduction in the trade deficit. Although CBO will not precisely define how much the trade deficit must decline in order for the economy to grow at the projected pace, they do note that "most forecasters expect real net exports to improve significantly in the near future, contributing importantly to economic growth by 1987."5/

TRADE DEFICITS AND GROWTH RATES

Whether or not the U.S. trade deficit--and therefore, the GNP growth rate--will improve by the requisite amount remains to be seen. Few economists, however, doubt that a direct connection exists between the current bout of rising trade deficits and the current bout of lethargic U.S. economic growth. But while it is commonplace to assert that this connection exists, it is not immediately clear how much faster the economy might have grown if the trade balance had not deteriorated so rapidly. Conceptually, however, this potential growth rate is simple to calculate.

According to conventional GNP accounting principles, economic growth during any given period is equal to the sum of

the change in consumption expenditures, gross private domestic investment expenditures, government expenditures, and net exports, where net exports are defined as the value of the export of goods and services minus the value of the imports of goods and services. In GNP accounting terms, a positive value for net exports means that the economy is generating the equivalent of a trade surplus. Conversely, when net exports are negative, as they have been for most of this decade, the economy is experiencing the functional equivalent of a trade deficit.

Algebraically, this accounting identity is expressed as:

$$\Delta \text{GNP} = \Delta C + \Delta I + \Delta G + \Delta NX$$

It is important to point out that for this analysis, the crucial variable affecting GNP growth is not the size of the net export component but the direction in which it is moving. A large trade deficit that is getting smaller will accelerate the GNP growth rate. Conversely, a small trade deficit that is getting larger will reduce the reported GNP growth rate.

The most recent GNP statistics offer a vivid illustration of the way in which these concepts can be used to generate a preliminary estimate of the amount by which a growing trade deficit depresses GNP growth. In mid-September, the Department of Commerce released revised estimates showing that second quarter GNP increased by \$5.5 billion, or at a 0.6% seasonally adjusted annual rate.^{6/} According to the Department of Commerce estimates presented in Table 1, this \$5.5 billion increase consisted of a \$35.7 billion increase in consumption expenditures, a \$19.4 billion decrease in gross private domestic

TABLE 1

COMPONENTS OF GNP INCREASE, 1986 SECOND QUARTER
(Change From Preceding Quarter, Billions of 1982 Dollars)

Real GNP	5.5
Consumption Expenditures	35.7
Gross Private Domestic Investment Expenditures	-19.4
Government Expenditures	17.0
Net Exports	-28.0
Real GNP During Preceding Quarter	3655.9
Annualized GNP Growth Rate	$4(5.5 \div 3655.9) = .006$
(Note: Totals do not add due to rounding)	

GNP GROWTH WITH CONSTANT TRADE DEFICIT, 1986 SECOND QUARTER
(Change From Preceding Quarter, Billions of 1982 Dollars)

Real GNP	33.5
Consumption Expenditures	35.7
Gross Private Domestic Investment Expenditures	-19.4
Government Expenditures	17.0
Net Exports	0.0
Real GNP During Preceding Quarter	3655.9
Potential Annualized GNP Growth Rate	$4(33.5 \div 3655.9) = .038$

Source: Gross National Product: Second Quarter 1986 (Revised),
U.S. Department of Commerce News, August 19, 1986,
Table 1.

investment expenditures (caused primarily by a decline in business inventories), a \$17.0 billion increase in federal, state, and local government expenditures, and a \$28.0 billion decrease in net exports as the U.S. goods and services deficit rose from an annual rate of \$125.9 billion during the first quarter to \$153.9 billion in the second quarter.

From this raw data we can calculate that if net exports had not declined by \$28.0 billion, real GNP during the quarter would have posted a \$33.5 billion advance, as opposed to the \$5.5 billion increase actually recorded. This \$28.0 billion of additional GNP would have raised the reported GNP growth from an annual rate of 0.6% to a more respectable annual rate of 3.8 percent, assuming no offsetting change in any other sector.

It is far more difficult, if not impossible, to quantify the impact which rising trade deficits have had over a longer time period because changes in the trade deficit would have resulted in corresponding changes in employment, wages, investment, monetary policy and so forth. Those changes would, in turn, affect the trade deficit and overall GNP growth. If, however, we simply assume for a moment that all other factors remained constant and the net export position of the United States had not deteriorated, annual GNP growth between 1981 and 1985 would have averaged a far more respectable 3.2%, instead of the 2.4% average rate actually recorded.

TRADE DEFICITS AND EMPLOYMENT

Some have argued that employment in the 1980s is the shining light of the economy. It is, in fact, true that employment has grown more rapidly during this decade than anyone would have predicted based on what has happened to GNP, personal income, or other indices of economic well-being. At the same time, it should be recognized that the economy's pace of new job creation has slowed significantly from that of the late 1970s. Moreover, nearly one-million manufacturing jobs disappeared during the past five years. After peaking in 1981 at 20.1 million jobs, manufacturing employment declined to 19.1 million jobs in July 1986.^{7/}

A major factor for the deceleration in the rate of new job creation as well as the absolute declines in manufacturing employment is the rising trade deficit. For example, the National Association of Manufacturers recently observed that "while there has been a great deal of political emphasis on the gross number of jobs created in a dynamic U.S. economy, it appears that there has been a permanent loss of jobs in manufacturing due to the impact of trade."^{8/}

Several recent Department of Commerce studies support this claim. According to one Department of Commerce estimate,^{9/} rising U.S. imports and declining U.S. exports have cost the U.S. approximately 1.8 million jobs, leaving the unemployment rate nearly 1.1% higher than it would have been without the rising trade deficit.

Looking only at the export side of the equation and using

somewhat different estimating procedures, a second Department of Commerce study^{10/} reports that export-generated employment alone dropped by 1.8 million jobs, or 25%, between 1980 and 1984. In the absence of this export-led decline, the study reports, the U.S. would have generated 6.2 million new jobs instead of the 4.4 million actually created. The rate of new job creation, in other words, would have been more than 33% higher.

According to this second Department of Commerce study, the manufacturing sector absorbed two-thirds of the job losses associated with declining U.S. exports. The study also found that declining levels of export-generated employment accounted for 80% of the manufacturing jobs lost between 1980-1984.

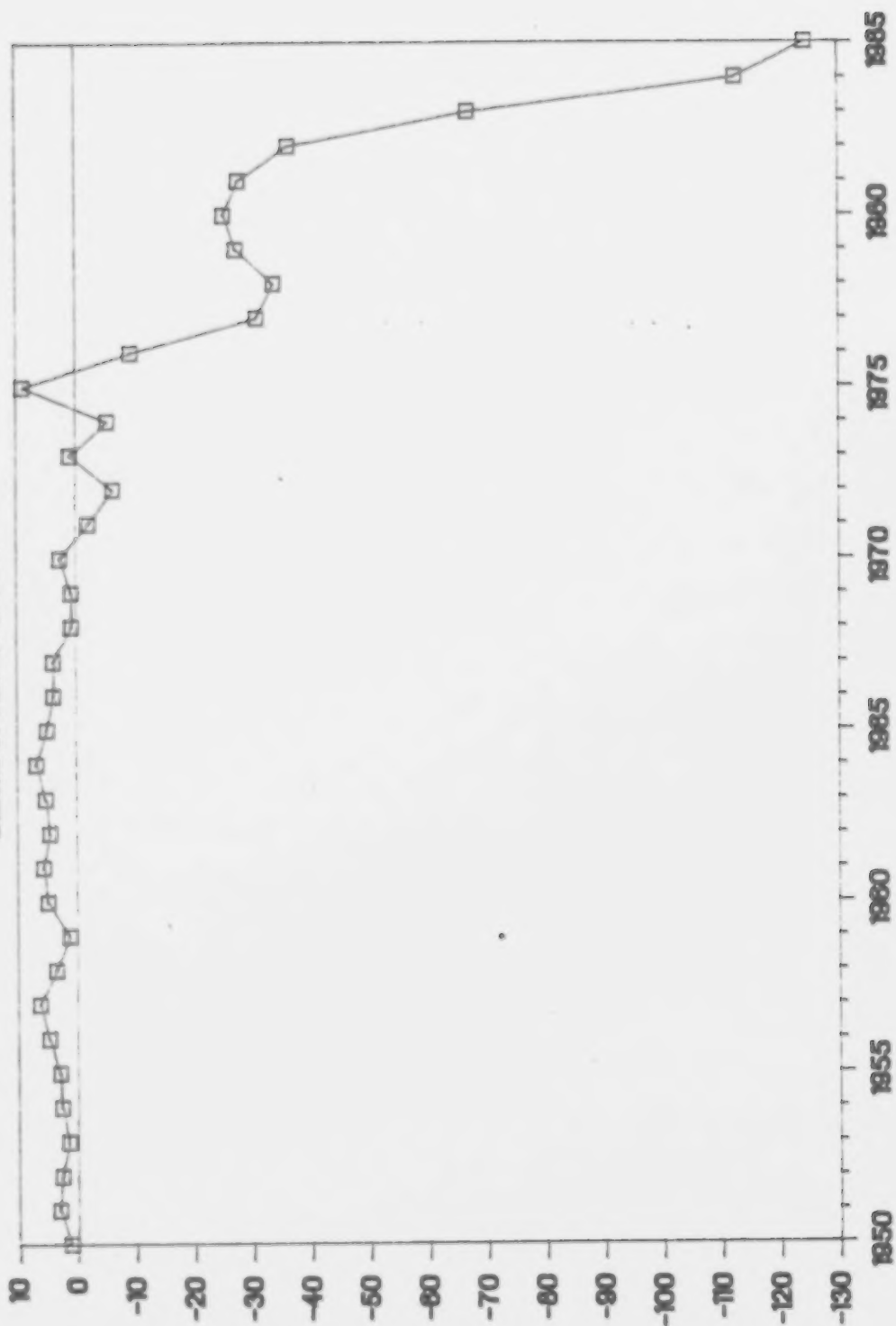
ANATOMY OF A TRADE DEFICIT

During the post-war period, the U.S. merchandise trade balance was not always in the red nor was it always a drag on economic growth (Chart 2). The U.S. entered the post-war period running modest trade surpluses and reached the current level of massive deficits after passing through three distinct stages of economic evolution.^{11/}

CHART 2

Merchandise Trade Balance

(billions of current dollars)



During the first stage, which lasted from 1950 to 1976, the trade balance oscillated in a narrow range, hovering between a \$6 billion surplus and a \$9 billion deficit. During this era, modest trade surpluses were the rule; deficits were the exception. The U.S. ran its first post-war deficit in 1971. It had its last trade surplus in 1975.

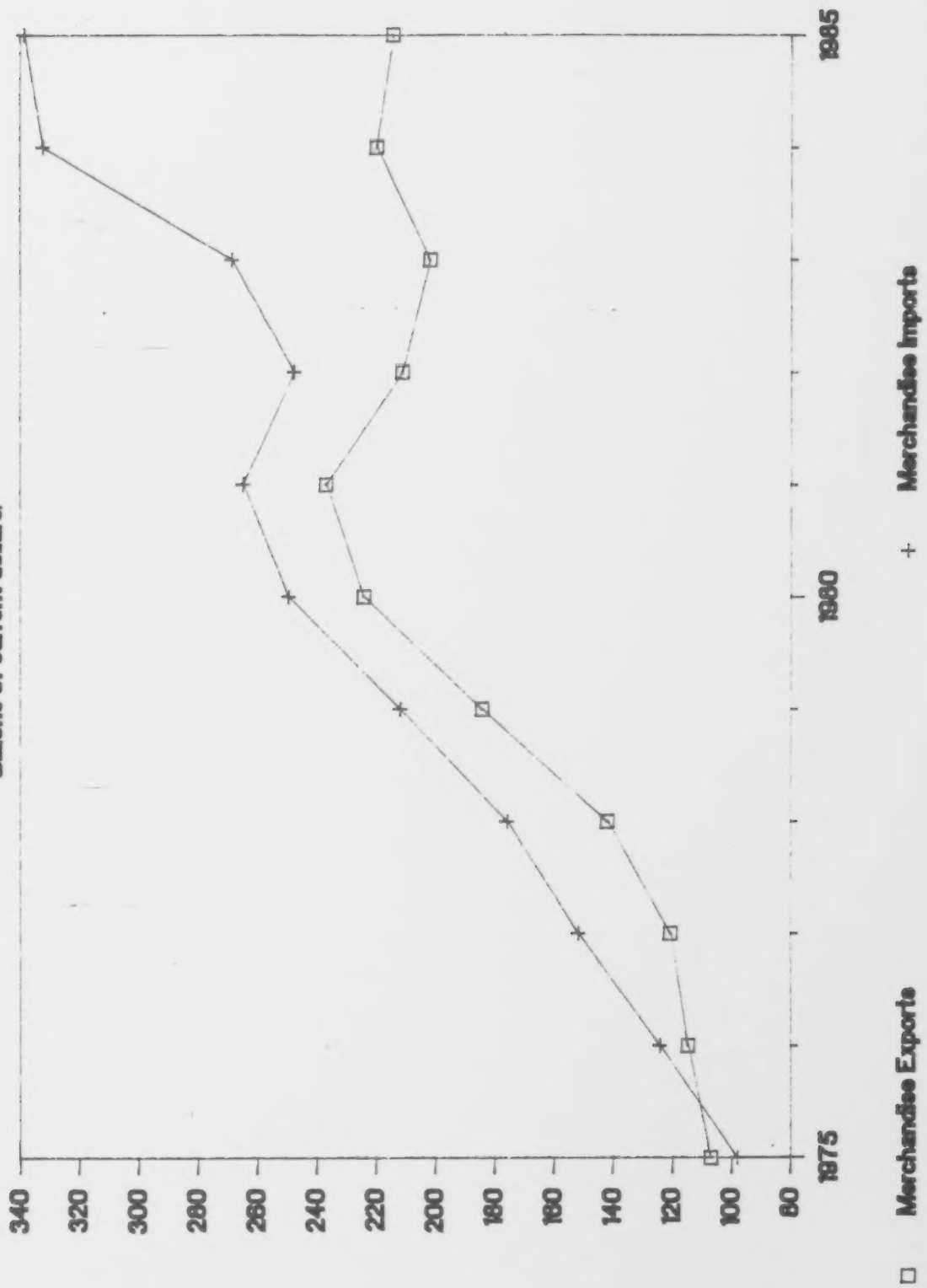
The second stage, lasting from 1977 to 1981, was one of persistent trade deficits. But despite rising prices for petroleum imports, the deficits were comparatively modest, ranging from a low of \$25 billion in 1980 to a high of almost \$34 billion in 1978. During this period, imports and exports were both growing at approximately the same pace (Chart 3). However, imports were consistently outpacing exports by an average of \$29 billion, leaving the U.S. with a cumulative \$146 billion deficit for the five years.

The U.S. entered the third and current stage in 1982. This stage is characterized by several distinct--and ominous--developments. First, the absolute value of U.S. exports declined in both 1982 and 1983, marking the first time since 1948 that U.S. exports declined for two consecutive years. As of mid-1986, U.S. exports still had not regained their 1981 level. Imports, meanwhile, resumed their upward surge after only a brief dip in 1982. By the end of 1985, they were \$73 billion above their 1981 level and slightly more than \$91 billion above their depressed 1982 level. Not surprisingly, the trade deficit ballooned from a relatively modest and financially tolerable \$36 billion level in 1982 to nearly \$125 billion in 1985.

CHART 3

Merchandise Trade, 1975-1985

(billions of current dollars)



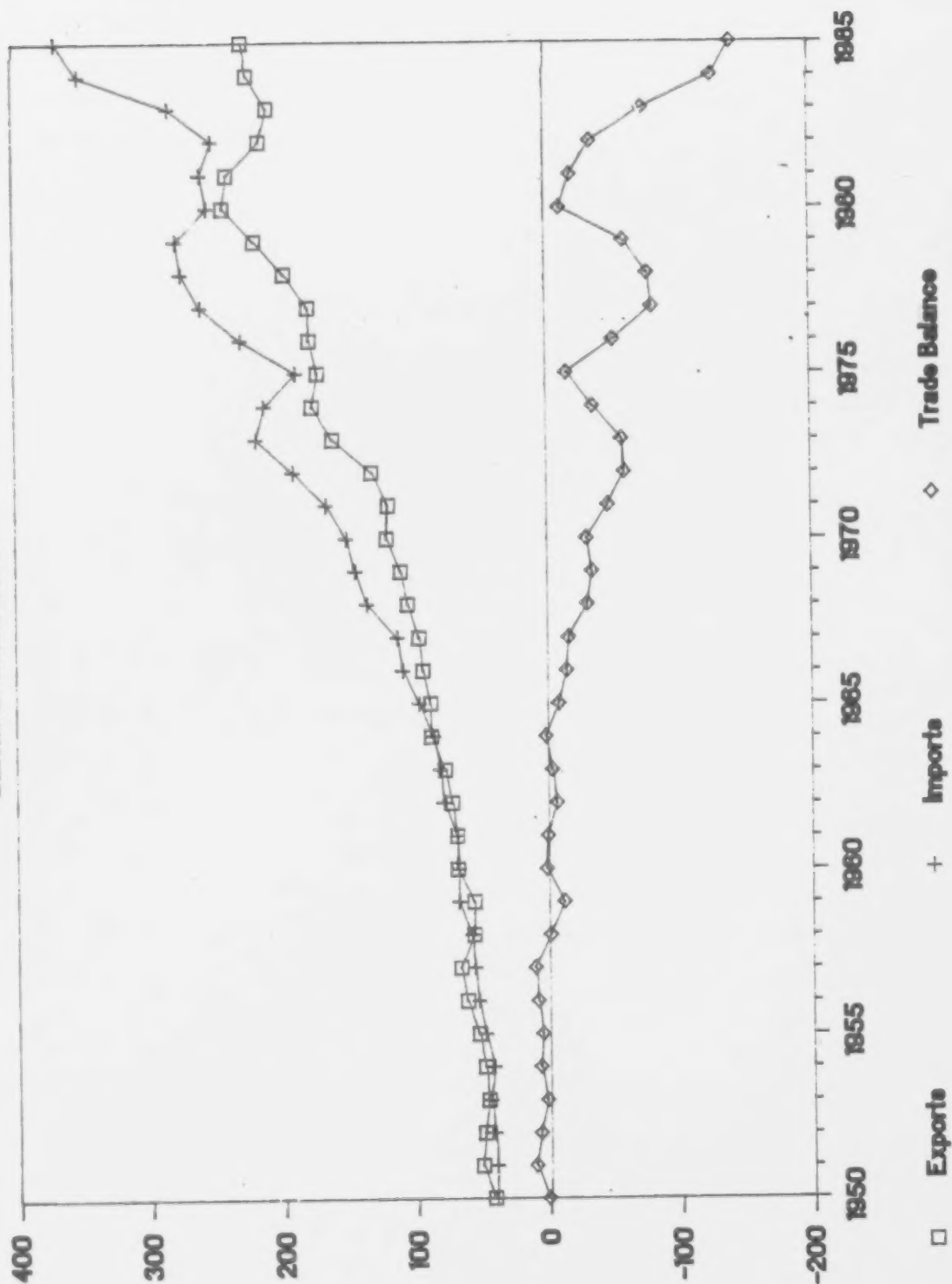
Measuring the merchandise trade balance in real 1982 dollars does little to alter the basic outlines of this story (Chart 4). The first stage, this time lasting from 1950 to only 1965, was one of relative trade balance. The period from 1966 to 1981, by comparison, was one of moderate real merchandise trade deficits. During this second stage, several years of increasing merchandise trade deficits were followed immediately by several years of decreasing deficits, so that the real merchandise trade deficit was reduced to approximately zero in both 1975 and 1980. Finally, from 1981 to the present, the real trade deficit deteriorated rapidly.

Even more ominous than these past trends, however, is the fact that by the time 1986 comes to a close, the cumulative merchandise trade deficit since 1981 could very well have passed the half trillion dollar mark. As a result, the U.S. will have been transformed from the world's largest creditor nation into its largest debtor--a development that could lead to chronic bouts of slow growth and declining standards of living for the foreseeable future.

CHART 4

MERCHANDISE TRADE

(billions of 1982 dollars)



Moreover, while the federal budget deficit is blamed for the foreign borrowing, and while a significant portion of our federal budget deficit is, in fact, financed by foreign purchases of U.S. Treasury bonds, the net balance of U.S. external debt would not have increased--even with the high federal deficits--had the trade balance not deteriorated so sharply. Instead, with a smaller trade deficit, foreign lending to the U.S. would have been offset by additional U.S. lending overseas, leaving the U.S. with a much lower net external debt.

THE U.S. BECOMES A DEBTOR NATION

During the first two post-war phases, the U.S. economy financed its comparatively moderate merchandise trade deficits with the surpluses generated on the services component of the balance of payments. In addition to such traditional services as law, accounting, insurance, banking, tourism, and transportation, the services portion of the balance of payments also includes such other items as interest and profits earned by U.S. individuals and businesses on their overseas investments. Indeed, for most of the post-war period, investment income accounted for between two-thirds and three-fourths of the services component.

During the first post-war economic stage, the U.S. generally generated surpluses on both the merchandise and services portions of its balance of payments. During the second stage, merchandise trade deficits were usually accompanied by a surplus on services. However, since the services surplus exceeded the moderate, but chronic, merchandise trade deficits, the combined goods and

services balance remained in the black (Chart 5).

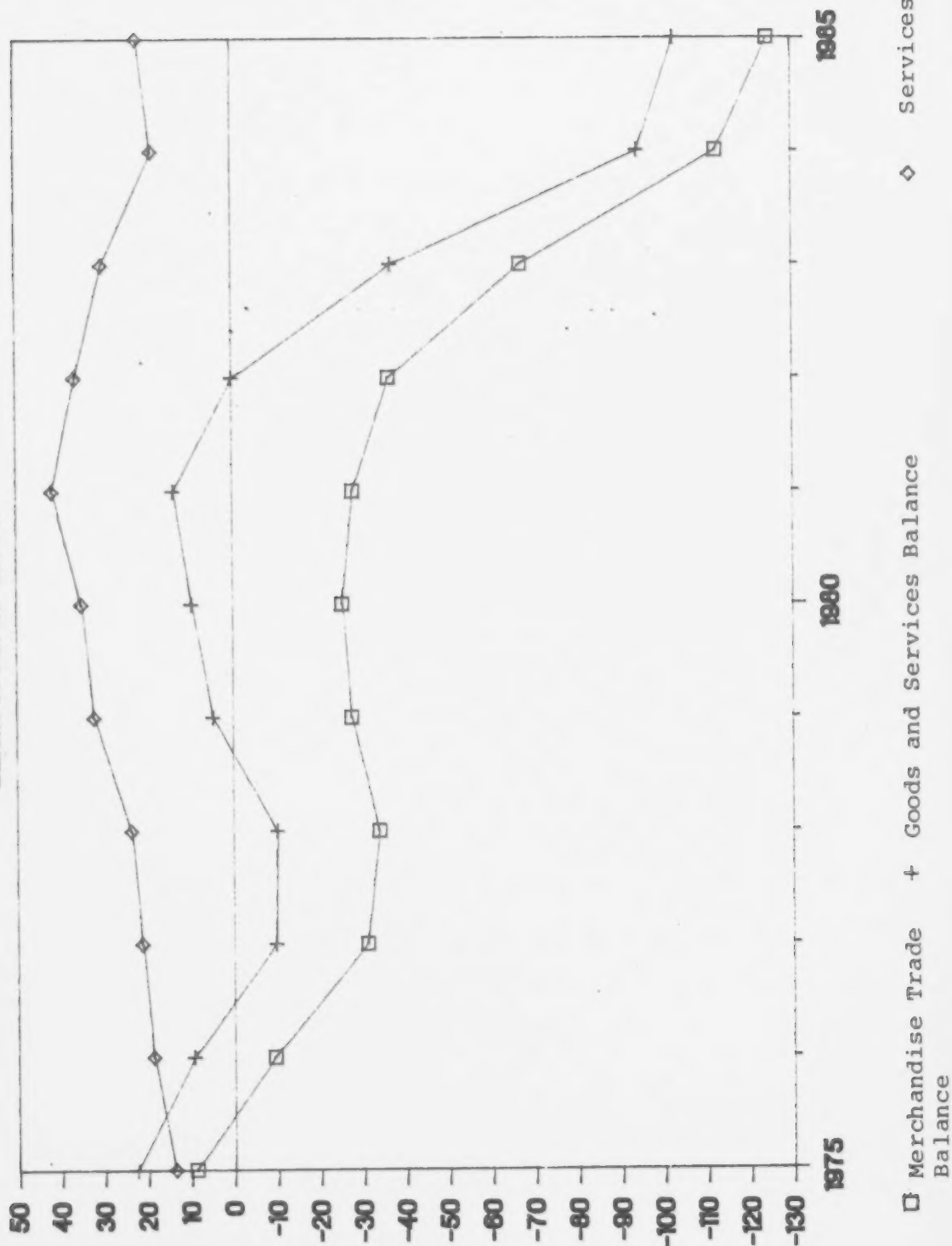
During phase two, in other words, the U.S. economy was like a family that was spending both its wage income and the interest on its savings account. This rate of spending can be sustained indefinitely. However, once the family starts spending more than its current earnings from wages and interest, it will have to finance the resulting deficit by pawning its assets, withdrawing funds from its savings account, and ultimately, by going into debt.

During phase three, the U.S. economy used all three of these techniques to finance its rapidly increasing trade deficit. Starting in 1982, the merchandise trade deficit exceeded the services surplus. As a result, the overall balance on goods and services moved into deficit for only the third time in over twenty years. However, unlike the two previous deficit episodes--1972 and 1977-1978--which were followed in quick succession by a resumption of surpluses, the goods and services balance this time shows no sign of moving into the black. If this trend persists, the U.S. may very well be on the threshold of a new economic phase, one that could have serious negative repercussions on the prospects for future U.S. growth and advances in living standards.

CHART 5

Goods and Services Trade, 1975-1985

(billions of current dollars)



The U.S. became a debtor nation in 1985.^{12/} This determination was made by tabulating the book value of overseas investments held by U.S. individuals and businesses and subtracting the book value of U.S. investments held by foreign investors. As long as the value of overseas investment owned by U.S. investors exceeded the value of foreign investment in the U.S., the U.S. was a creditor nation.

The U.S. reached its zenith as a creditor nation in 1981, when its net international investment position peaked at \$140.7 billion (Table 2). At that time, U.S. overseas assets totalled \$719.7 billion, while foreign assets in the U.S. were \$579 billion.

Beginning in 1982, the balance of goods and services moved into deficit, forcing the U.S. to finance the overall deficit by selling assets and going into debt. The result has been that between 1981 and 1985, foreign-owned assets in the U.S. surged by \$480 billion, to just over \$1 trillion while U.S. assets abroad increased by \$233 billion. Consequently, the U.S. was transformed from a \$140 billion creditor to a \$107 billion debtor, with an additional \$130 billion to \$140 billion expected to be added to the outstanding debt in 1986.

TABLE 2

INTERNATIONAL INVESTMENT POSITION OF THE UNITED STATES, 1970-1985
(Millions of Dollars)

<u>Year</u>	<u>U.S. Assets Abroad</u>	<u>Foreign Assets In U.S.</u>	<u>Net International Investment Position</u>
1970	\$165,385	\$ 106,912	\$ 58,473
1971	179,004	133,493	45,511
1972	198,694	161,658	37,036
1973	222,430	174,536	47,894
1974	255,719	196,988	58,731
1975	295,100	220,860	74,240
1976	347,160	263,582	83,578
1977	379,105	306,364	72,741
1978	447,847	371,730	76,115
1979	510,563	416,106	94,457
1980	606,867	500,830	106,037
1981	719,687	578,983	140,704
1982	824,875	688,675	136,200
1983	874,053	785,559	88,494
1984	898,187	893,803	4,384
1985	952,367	1,059,807	-107,440

Source: U.S. Department of Commerce, "The International Investment Position of the United States in 1985," Survey of Current Business, June 1986, Table 2, p. 28.

Up to now, this shift to debtor nation status has been relatively manageable. For most people, it has not brought a noticeable reduction in living standards. In fact, by allowing the U.S. to consume more than it was producing, the inflow of foreign capital may have actually helped to at least temporarily support standards of living. However, simple mathematics shows that those beneficial effects can only be transitory. At some point, the consequences of being a debtor nation will have to be faced. Those consequences will be both noticeable and painful.^{13/}

According to even the most optimistic forecasts, the U.S. trade deficit is expected to remain above \$100 billion through at least 1989. If it does, the net debt of the U.S. will increase by at least an additional \$300 billion and could quite conceivably top the one trillion dollar mark as early as 1990. At an interest rate of between 7% and 8%, the interest payments on this additional \$300 billion of debt will increase by at least \$20 billion to \$25 billion, thereby driving the services component of the U.S. balance of payments into permanent deficit.

For a while, the U.S. might be able to finance both its merchandise and services deficits by borrowing more from overseas lenders. But this can only be a temporary solution. Without an improvement of the merchandise trade balance, additional borrowing will only drive the services component deeper into the red and increase the overall goods and services deficit. The amount of money that will have to be borrowed in future years will rise exponentially, increasingly and inevitably placing the destiny of the U.S. economy in the hands of foreign investors.

There are a variety of reasons that foreign investors may be less willing to continue lending the U.S. additional funds at a pace approaching \$100 billion to \$150 billion per year and at an interest rate that will not stifle U.S. economic growth. Paramount among them is the threat of a sharp dollar devaluation. Under those circumstances, even extremely high rates of interest may not compensate foreign investors for the potential losses they would suffer from a dollar devaluation.

Consequently, if foreigners stop lending at an affordable interest rate, or even if their pace of lending decelerates, the U.S. will have no choice but to start converting its current \$150 billion to \$160 billion trade deficit into a \$10 or \$20 billion trade surplus. However, generating this swing in the merchandise trade accounts will impose a wrenching adjustment on the world trading system. Instead of acting as the world economy's economic locomotive and purchasing the lion's share of the world's increased exports, the U.S. economy would no longer be in a financial position to sustain its consumption of foreign products. As a result, foreigners would discover that their U.S. markets have suddenly disappeared, even though the U.S. had erected no trade or tariff barriers. This, in turn, could spark a global recession.

Compounding the problem is the fact an additional steep fall in the dollar would pose a serious threat to U.S. standards of living. Under those circumstances, generating a trade surplus may prove to be a Pyrrhic victory. Although the turnaround in the trade accounts will have the effect of increasing reported GNP

growth rates, the U.S. will be exporting more and importing less because it is selling its produce at bargain basement prices and not earning enough to purchase anything in exchange. Put another way, as a nation we will be working more while consuming and investing less. Like the Latin American debtor nations, in other words, the U.S. will be forced to use the additional output to satisfy the demands of its creditors, not to increase productivity and raise standards of living.

II. FASTER GROWTH ABROAD, FASTER GROWTH AT HOME

Because the U.S. trade accounts have become so unbalanced, it is difficult to see how the U.S. can engineer a soft landing--one that restores balance without threatening either world prosperity or U.S. standards of living. However, in an attempt to sustain the current recovery--both at home and abroad--as well as provide a second stage boost to the world economy, administration officials have embarked on a two-pronged strategy. First, in last September's Plaza Agreement, the G-5 nations--Germany, Japan, Great Britain, the U.S. and France--announced that they would embark on a coordinated policy to reduce the dollar's value. The expectation was that increasing the competitiveness of U.S. products in overseas markets and reducing the price advantage of foreign products in U.S. markets would, at a minimum, help stabilize the U.S. trade deficit. And as the analysis in the preceding section demonstrated, as soon as the U.S. trade deficit stops increasing, U.S. GNP growth should accelerate markedly.

However, for the U.S., the international disequilibrium may

now have become so great that even a modestly-declining trade deficit may be inadequate to resolve the long term payments problem, irrespective of any salutary effect it has on reported GNP growth. Simply stated, trade deficits averaging even \$100 billion from 1987 to 1989 could push the U.S. external debt past the one trillion dollar mark by the end of the decade and close to the two trillion dollar mark in an additional eight or nine years.

Finding the foreign capital to finance these deficits may become increasingly difficult. Perhaps this explains why administration officials are now coupling the G-5 agreement with calls for Germany and Japan to stimulate their economies and increase their domestic demand. As administration economists explain it, faster growth among our principal industrial country trading partners will help reduce the U.S. trade deficit--and hence the external disequilibrium--in several ways.

First, as their economies grow more rapidly, Germany and Japan should begin importing more U.S. products, thereby helping to reduce the U.S. trade deficit. Second, once their domestic markets begin growing more rapidly, German and Japanese producers will not be so dependent on U.S. customers. For example, between 1981 and 1985, somewhat more than 25% of Japan's GNP growth and nearly 50% of Germany's total GNP growth was generated via foreign demand and exports. The U.S. absorbed virtually all of the Japanese and German export increases.^{14/} However, by taking steps to boost their internal markets, neither country will have to export as much in order to sustain any particular rate of

growth. This, too, should help reduce the pressures on the U.S. trade deficit.

Finally, as Germany and Japan begin to grow faster, the administration hopes that their economies will act as economic locomotives, stimulating faster growth among their trading partners. This, in turn, will provide U.S. exporters with more buoyant markets at the same time that it reduces everyone else's need to concentrate their export drives on U.S. markets. Consequently, besides improving the U.S.-Japan and U.S.-Germany bilateral trade balances, faster growth in Germany and Japan should help to reduce the U.S. trade deficit with a much wider group of trading partners.

Administration economists are correct in noting that faster growth among U.S. trading partners is a significant ingredient for more rapid growth in the U.S. and a lower merchandise trade deficit. And in addition to growing more rapidly, several U.S. trading partners could take additional measures to open their markets to U.S. products. This will also help expand U.S. exports, especially now that the dollar's high value is no longer pricing U.S. products out of so many markets.

Nevertheless, administration officials appear to overestimate the extent to which open markets and faster growth in Germany and Japan will help to reduce the U.S. merchandise trade deficit and accelerate U.S. GNP growth rates. And conspicuous by its absence in their calls for faster growth is any mention of the role that could be played by less developed countries (LDCs) in general and the major Latin American debtor

nations in particular.

This omission could seriously undermine the administration's international economic strategy. As the following analysis will show, during the late 1970s, when net exports were a key factor in keeping the U.S. economy out of recession, a large portion of the growth in U.S. exports was coming from sales to developing countries. The Latin American debt crisis extinguished that important--and rapidly growing--source of demand for U.S. products. Consequently, the debt crisis may be one of the major factors retarding U.S. as well as world economic growth. It is no coincidence, for example, that the rapid growth of U.S. merchandise trade deficits more or less coincides with the onset of the debt crisis. Nor will it be a coincidence if the U.S. discovers it is having difficulty eliminating its merchandise trade deficit and boosting economic growth as long as the debt crisis continues to stifle U.S. exports to debtor nations.

RISING MANUFACTURING IMPORTS

Many analyses of the U.S. trade deficit emphasize the recent surge of imports, primarily from Japan and such East Asian newly industrializing countries (NICs) as Hong Kong, South Korea, Taiwan and Singapore. Imports to the U.S. have indeed surged (Table 3), rising from \$265 billion in 1981 to \$339 billion in 1985, with additional increases slated for 1986. During this period, the value of petroleum imports fell from \$78 billion in 1981 to \$50 billion in 1985. Consequently, although total imports increased by "only" \$74 billion, non-petroleum imports were rising much faster. Between 1981 and 1985, for example, manufactured imports increased by approximately \$100 billion, or 75 percent.

Import surges of this magnitude, especially when they are concentrated in a relatively small number of manufacturing sectors, have a noticeable--and disruptive--impact on the affected industries. Not surprisingly, they receive a great deal of well-deserved attention and are the subject of vociferous complaints. But placing the blame for the exploding trade deficit--as opposed to the trade related problems of specific industries--solely on the import side of the balance of payments ledger may not capture the full complexity of the U.S. merchandise trade problem.

TABLE 3

DISTRIBUTION OF U.S. MERCHANDISE IMPORTS, 1981 AND 1985

U.S. Imports From:	(Billions of Dollars)	
	1981	1985
World	\$265.0	\$338.8
Industrial Countries	144.3	219.8
EEC	41.4	62.5
Germany	11.3	19.5
Canada	48.2	71.1
Japan	37.6	65.7
Western Hemisphere	39.0	46.1
Asia, Except Japan	55.2	60.7
Hong Kong	5.4	7.9
Korea	5.1	9.9
Singapore	2.1	4.1
Taiwan	8.0	15.4
Africa	24.6	9.8
Memoranda:		
OPEC	49.9	22.6
Petroleum and Products	77.8	50.5

Source: U.S. Department of Commerce, "U.S. International Transactions, First Quarter 1986," Survey of Current Business, June 1986, Table 3.

DWINDLING U.S. EXPORTS

The value of total imports measured as a percentage of GNP has remained steady between 1981 and 1985 (Table 4), aided in part by the \$30 billion decline in petroleum imports. Meanwhile, exports were declining from \$237 billion or 8% of GNP in 1981 to \$214 billion or 5.3% of GNP in 1985. In the wake of both this absolute and relative decline in the level of export revenues, the U.S. merchandise-trade deficit rose from 1% of GNP in 1981 to 3.7% in 1985. However, if exports had merely retained the 8% share of GNP posted in 1981, rather than growing faster than GNP as they did during the previous decade, the U.S. trade balance would have looked quite different.

In 1985, U.S. exports would have totalled \$319 billion, instead of the \$214 billion actually recorded, for a net increase of \$105 billion (Table 5 and Chart 6). As a result, even with the \$74 billion growth of imports, the U.S. merchandise trade deficit would have declined during the 1980s. In 1985, it would have been less than \$20 billion rather than \$124 billion. The U.S. net external debt, meanwhile, would have been at least \$300 billion less than it is today. Consequently, interest payments on that net external debt would be at least \$24 billion less, leaving the goods and services balance with a large surplus.

TABLE 4

U.S. MERCHANDISE TRADE AS A PERCENTAGE OF GNP, 1960-1985

<u>Year</u>	<u>Exports</u>	<u>Imports</u>	<u>Balance</u>
1960	4.1	2.9	1.2
1961	3.9	2.8	1.1
1962	3.8	2.9	0.9
1963	3.9	2.9	1.0
1964	4.2	2.9	1.3
1965	4.0	3.1	0.9
1966	4.0	3.4	0.6
1967	4.0	3.4	0.6
1968	4.0	3.8	0.2
1969	4.1	3.8	0.3
1970	4.4	4.1	0.3
1971	4.1	4.3	-0.2
1972	4.3	4.8	-0.5
1973	5.5	5.4	0.1
1974	7.0	7.3	-0.3
1975	6.9	6.3	0.6
1976	6.7	7.2	-0.5
1977	6.3	7.9	-1.6
1978	6.6	8.2	-1.6
1979	7.6	8.8	-1.2
1980	8.5	9.5	-1.0
1981	8.0	9.0	-1.0
1982	6.9	8.0	-1.1
1983	6.1	8.2	-2.1
1984	6.0	9.3	-3.3
1985	5.3	9.0	-3.7

Source: For 1960 to 1984 data: Annual Report of the President of the United States on the Trade Agreements Program, Transmitted to Congress February 1986, Appendix Z, Table II, p. 219.
 For 1985 data: International Monetary Fund, International Financial Statistics, July 1986, series 70, 71, 99a.

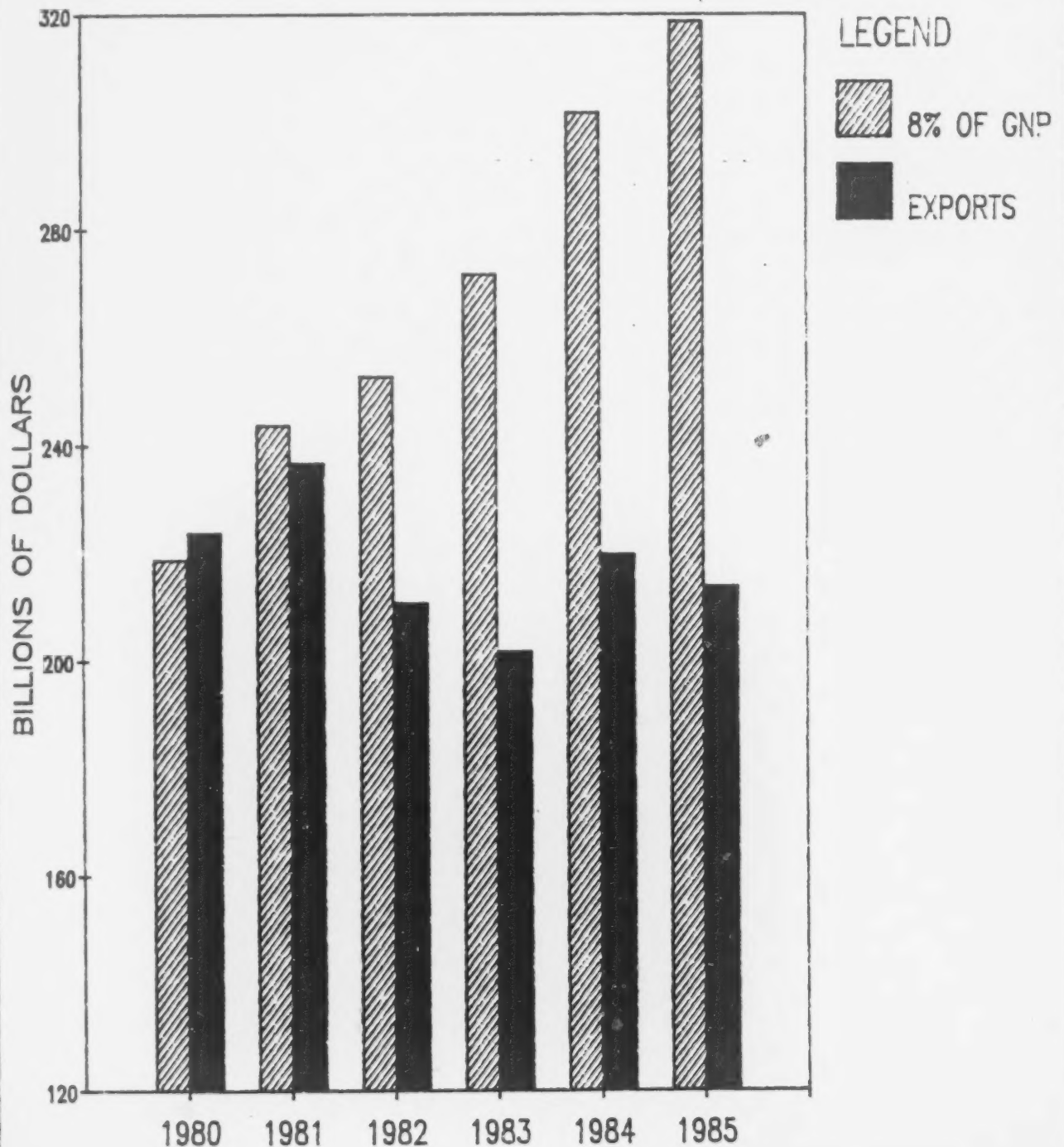
TABLE 5

U.S. MERCHANDISE TRADE BALANCE, 1981 AND 1985
(Billions of Dollars)

	<u>1981</u>	<u>1985</u>
Imports	\$265.0	\$338.8
Exports (actual)	237.0	214.4
Exports (Constant Share)		319.0
Actual Trade Balance (Actual Exports minus Imports)	-28.0	-124.4
Constant Share Trade Balance (Constant Share Exports minus Imports)		-19.8

CHART 6

THE GAP IN EXPORT GROWTH MERCHANDISE EXPORTS VS. 8% OF GNP



PREPARED BY THE JOINT ECONOMIC COMMITTEE

Approximately \$52 billion of those additional exports would be generated by sales to industrial countries (Table 6). Together, Germany and Japan would have contributed slightly more than 25% of the additional industrial country total. However, even if Germany and Japan imported the same share of U.S. GNP as they did in 1981, the additional \$12 billion of U.S. exports would not be sufficient to eliminate even 10% of the current trade deficit.

Another possible yardstick for measuring the potential growth of U.S. exports is not the rate of U.S. GNP growth but the rate of German and Japanese GNP growth. For example, Japan's GNP in 1981 was Y256.8 trillion. By the fourth quarter of 1985, its GNP was running at a Y324.8 trillion annual rate, for a cumulative increase of 30 percent.^{15/} U.S. exports to Japan in 1981 were \$21.8 billion. However, if they had kept pace with Japanese GNP growth, they would have increased by \$6.5 billion, to \$28.3 billion. In fact, U.S. exports to Japan in 1985 were only \$22.6 billion, so the U.S. would have had an additional \$5.8 billion of exports.

Similarly, Germany's GNP in 1981 was DM1545.1 billion. By 1985 it had risen 20% to DM1837.9 billion. U.S. exports to Germany in 1981 were \$10.2 billion. However, if they had kept pace with Germany's GNP growth, they would have risen to \$12.2 billion, an increase of \$3.2 billion over the actual 1985 level. Altogether, if U.S. exports to Germany and Japan had grown as fast as Germany's and Japan's GNP, U.S. exports in 1985 would have been only \$9 billion higher.

TABLE 6

DISTRIBUTION OF U.S. MERCHANDISE EXPORTS
(Billions of Dollars)

<u>U.S. Exports To:</u>	<u>1981</u>	<u>1985 Actual</u>	<u>1985 Constant Share</u>	<u>1985 Constant Share Minus 1985 Actual</u>
World	\$237.0	\$214.4	\$319.0	\$104.6
Industrial Countries	141.9	139.0	191.4	52.4
EEC	51.3	45.1	68.9	23.8
Germany	10.5	8.9	14.0	5.1
Canada	46.0	53.8	61.8	8.0
Japan	21.7	22.1	29.0	6.9
Western Hemisphere	42.8	30.7	57.4	26.7
Asia, except Japan	39.4	35.2	52.9	17.7
Hong Kong	2.6	2.7	3.5	0.8
Korea	5.0	5.7	6.7	1.0
Singapore	2.9	3.4	3.8	0.4
Taiwan	4.0	4.2	5.1	0.9
Africa	7.8	5.6	10.5	4.9
Memoranda:				
OPEC	21.0	11.4	28.0	16.6

Source: See Table 5.

Thus, no matter which yardstick is used, the story is the same: If the U.S. trade deficit is going to be reduced in a way that does not automatically entail a sharp reduction in U.S. standards of living, demand in markets outside the industrial countries will also have to be revived. For the U.S., that can only mean boosting demand in the LDCs, and particularly in the Latin American debtor nations.

The importance of the non-industrial countries can be seen from the fact that while they consumed less than 40% of U.S. exports in 1981, they account for nearly 50% of the difference between actual 1985 exports and the level of exports that would have prevailed if the growth of U.S. exports had kept pace with the growth of U.S. GNP (Table 6). In other words, nearly 50% of the potential export sales lost between 1981 and 1985 is concentrated in developing countries.

In Latin America, the relative loss is even greater. Although they purchased only 15% of U.S. exports in 1981, non-industrial Western Hemisphere countries, primarily Latin American debtor nations, are responsible for slightly more than 25% of the lost potential export sales. Moreover, the potential contribution of Latin American markets to reviving U.S. exports appears to be twice as great as that of Germany and Japan. The Latin American contribution would also appear to equal almost 50% of the combined contribution of the entire industrial world.

In addition to accounting for the lion's share of the loss in potential export revenues, developing countries accounted for 87% of the \$23 billion recorded decline in aggregate U.S. exports (Table 6). Exports to Western Hemisphere countries, primarily Latin American debtor nations, fell by approximately \$12 billion, or 55% of the U.S. export decline. Exports to OPEC countries fell by just under \$10 billion, as declining oil prices and falling sales volumes eroded their purchasing power. Africa and Asia combined accounted for an additional \$6 billion of dwindling U.S. exports.

Despite the rising dollar, U.S. exports to industrial countries fell by a comparatively modest \$3 billion, or less than 2 percent. Exports to Germany declined by \$1.6 billion; exports to Japan actually rose by \$0.4 billion. However, both countries combined only accounted for 13.6% of total 1981 U.S. exports and generated slightly more than one percent of U.S. GNP.

U.S. EXPORTS AND THE LATIN AMERICAN DEBT CRISIS

As the preceding analysis indicates, a large portion of the actual U.S. export declines and potential export growth is concentrated in developing countries in general and the heavily-indebted Latin American countries in particular. The Latin American countries, of course, have been in the midst of a severe debt crisis for the past four years. Therefore, it would seem only natural to blame the decline of U.S. exports to the region on the debt crisis.

However, it now appears that falling U.S. exports to Latin America are not an inevitable or unavoidable consequence of the

debt crisis. Rather, as a previously-released staff study has documented,^{16/} they are the direct outgrowth of administration policies for managing the debt crisis--policies which are tantamount to telling debtor nations that they must promise to continue paying interest and stop purchasing U.S. products. The result, not surprisingly, has been declining U.S. industrial and agricultural exports, falling commodity prices, rising unemployment, and sluggish economic growth. Obviously, repayment should occur, but the question is what repayment schedule represents a prudent balance between the interests of the banks, the debtor nations, and the U.S. economy. The details of administration policies need to be examined from that vantage point.

That examination suggests that in devising policies for managing the debt crisis, administration officials start by calculating how much interest each country owes. Debtor nations are then encouraged to make whatever trade adjustments are needed to ensure that they have enough foreign exchange on hand to make those interest payments. For the most part, this means that debtor nations are under strict requirements to increase their exports and reduce their imports.

But if every debtor nation must export more and import less, at least one other country must be willing to export less and import more. Up to now, at least, that burden has been carried primarily by the U.S. economy, and particularly by U.S. exporters and their workers.

In effect, by sacrificing their sales and jobs so that

debtor nations can fully meet all interest payments, U.S. exporters and workers have been subsidizing the bad lending policies of U.S. and other money center banks. To add insult to injury, U.S. workers and exporters are also bailing out European and Japanese banks. U.S. banks have only 30% of Latin America's outstanding debt owed to all private creditors.^{17/} Yet, despite the fact that U.S. banks hold less than one third of the outstanding loans, the U.S. economy has been bearing far more than one-third of the burden of ensuring that every commercial bank receives complete and timely interest payments.

For example, between their peak in 1981 to the end of 1985, the IMF reports that Latin American imports fell from \$123 billion to \$82 billion, a decline of \$41 billion or 33 percent.^{18/} Approximately \$11 billion of that amount represents decreased purchases from oil-exporting countries, leaving a net decline of \$30 billion from other countries. Industrial countries absorbed \$23 billion of that decline, with the U.S. absorbing approximately 50%, or \$11 billion, of the industrial country total (Table 7). Germany's export losses were \$2.2 billion; Japan's export decline was \$2.4 billion.

U.S. exports to the region declined by 26%, about the same rate of decline as Japan's and somewhat below Germany's rate of decline. However, even though the U.S. rate is similar to the rate posted by other industrial countries, the negative impact on the U.S. economy has been proportionately much greater.

TABLE 7

ORIGIN OF LATIN AMERICAN IMPORTS 1981-1985
(Billions of Dollars)

	1981	1982	1983	1984	1985	Change 1981-1985	
						Amount	Percent
Total	\$123.6	\$101.2	\$79.1	\$85.4	\$82.2	\$41.4	33.5%
Industrial Countries	80.3	65.2	49.8	56.0	56.9	23.4	29.1
United States	42.1	33.6	25.7	29.7	31.0	11.1	26.3
Germany	6.0	4.5	3.8	4.1	3.8	2.2	36.6
Japan	9.8	8.6	5.8	7.6	7.4	2.4	24.4
Oil Exporting Countries	21.2	17.4	14.1	12.9	10.6	10.6	50.0

Source: International Monetary Fund, Direction of Trade Statistics Yearbook, 1986, p. 45, 49.

At its peak, Latin America consumed 15% of all U.S. exports. By comparison, the corresponding figures for Germany and Japan are 3.4% and 6.4% respectively. In other words, even though the rates of decline were proportionate, the U.S. was losing a large portion of one of its major markets, while Germany and Japan were losing a comparatively small market. Consequently, the impact on their economies was much less.

Moreover, by 1981, Latin America was importing \$70 billion more than in 1976 (Table 8). In aggregate terms, \$50 billion of that increase was from industrial countries with another \$7 billion coming from oil-exporting countries. The U.S. supplied \$28 billion, or more than half of the additional Latin American imports originating in industrial countries. Japan's exports to Latin America, meanwhile, rose by \$5.8 billion and Germany's by \$3.2 billion. Thus, the growth of U.S. exports to Latin America was five times that of Japan and nine times that of Germany.

The importance of the Latin American market for the U.S. economy can also be seen from the fact that between 1976 and 1981, total U.S. exports increased from \$115 billion to \$237 billion. Even though they constituted only 15% of the U.S. export market in 1981, Latin American markets provided 25% of the growth of U.S. exports between 1976 and 1981. By comparison, Latin America accounted for only 4% and 7% respectively of the growth in Germany and Japan's exports. The U.S., in other words, has been losing a much larger market than other industrial countries and one that, until the onset of the debt crisis, had been growing more rapidly.

TABLE 8

ORIGIN OF LATIN AMERICAN IMPORTS 1976-1981
(Billions of Dollars)

	1976	1977	1978	1979	1980	1981	Change 1976-1981	
							Amount	Percent
Total	\$53.4	\$58.0	\$64.7	\$91.6	\$120.5	\$123.6	\$70.2	131.4%
Industrial Countries	30.1	32.8	39.6	58.4	74.8	80.3	50.2	166.7
United States	14.3	14.7	18.2	28.4	38.7	42.1	27.8	194.4
Germany	2.8	3.0	3.6	5.1	6.2	6.0	3.2	114.3
Japan	4.0	4.8	5.4	6.1	8.3	9.8	5.8	145.0
Oil Exporting Countries	14.3	14.8	13.7	16.0	24.2	21.2	6.9	48.2

Source: For 1976-1978 Data: International Monetary Fund, Direction of Trade Statistics
Yearbook, 1980, p. 47.
For Remaining Data: Same as Table 9.

For U.S. exporters, the Latin American market was even more important than these growth statistics would imply. The U.S. Department of Commerce, for example, recently noted, "Latin America had been one of the fastest growing markets for U.S. exports before the onset of the debt crisis...U.S. exports in 1985 were \$11.7 billion less than in 1981 and in not one Latin American country have they returned to their level of that year."^{19/}

However, as bad as these statistics may be, they may actually understate the loss to U.S. producers. According to another recent study, "The debt crisis effect on the financial health of manufacturers is understated by figures detailing loss of sales or jobs. This is because sales to Latin America typically have higher profit margins than domestic sales....Because of these high profit margins, the percentage loss of profits due to the [debt] crisis is higher than the percentage loss of sales."^{20/} That report goes on to note that American firms are able to reap these high profits because they enjoy a number of marketing advantages over their Japanese and European competitors. Paramount among them is the fact that "Latin American buyers believe that American products are the top of the line....Executives in Latin America have a high regard for American products." For the past four years, however, the administration policies for managing the debt crisis have been making it impossible for Latin Americans to indulge their preference for purchasing products that are made in the USA.

According to some observers, the 1976-1981 export boom was financed by excessive and unsustainable lending by commercial

banks and borrowing by debtor nations. Similarly, others would argue that the export declines since 1981 are not the result of administration policies but external factors such as the overvalued dollar. However, the data do not support either hypothesis.

Between 1976 and 1981, when Latin American imports of U.S. products were growing rapidly, debtor nations had either modest trade deficits or, in some cases, merchandise surpluses (Table 9). Thus, as far as Latin American imports are concerned, most of the large Latin American debtor nations seemed to be operating more or less on a pay-as-you-go basis. Even in the three debtor nations with cumulative trade deficits, the amount of new borrowing was much greater than the trade deficit. Except for Chile, interest payments were a larger drain on the balance of payments than merchandise trade and non-financial services combined. A majority of the new borrowing, in other words, was used either to finance interest payments or, in some instances, to finance capital flight. Bank lending, however, was not necessarily helping to sustain U.S. exports.

TABLE 9
LATIN AMERICA: SELECTED BALANCE OF PAYMENTS STATISTICS, 1976-1981
(Billions of Dollars)

	Merchandise Trade Balance				1981	Cumulative Trade Balance 1976-1981	Cumulative Interest Payments 1976-1981	Growth of External Debt 1976-1981
	1976	1977	1978	1979	1980			
Argentina	1.1	1.8	2.9	1.8	-1.3	0.7	8.6	25.2
Brazil	-2.4	-0.1	-1.1	-2.7	-2.8	1.2	29.8	45.3
Chile	0.6	0.0	-0.4	-0.4	-0.8	-2.6	5.0	10.8
Columbia	0.6	0.7	0.6	0.5	-0.2	-1.5	2.7	4.6
Mexico	-2.6	-1.0	-1.9	-3.2	-3.7	-4.5	23.9	53.7
Peru	-0.7	-0.5	0.3	1.5	0.8	-0.6	3.3	3.4
Venezuela	1.9	-0.7	-2.1	4.2	9.1	7.8	12.2	8.3

Source: Inter-American Development Bank, External Debt and Economic Development in Latin America, (January 1984), Table 11 and Appendix 2.

With respect to the post-1981 period, if the overvalued dollar were to blame for the loss of U.S. exports to the region, Latin American nations would be expected to shift their purchases from countries whose currency is rising to those whose currencies are falling. Specifically, during the 1980s, debtors should have been substituting Japanese and German products for U.S. products. The fact that countries with falling currencies as well as the U.S. with its rising currency all lost approximately equal shares of their Latin American export markets suggests that relative currency values were probably not to blame.

Moreover, the annual ups and downs of Latin American purchases of U.S. products since 1981 shows a close correlation with specific debt crisis events. For example, the Department of Commerce^{21/} reports that, between 1983 and 1985, Mexico increased its imports from \$8 billion to \$13.4 billion. During that period, U.S. exports to Mexico increased by \$4.5 billion. In other words, even though the dollar was rising for most of this period, U.S. exporters captured 83% of the growth in the Mexican market. While these additional sales provided a welcome respite from the general trend of declining U.S. exports, they were also one of the factors--even before last year's earthquake and this year's slide in oil prices--sparking Mexico's most recent round of debt repayment difficulties.

Argentina offers another excellent case study of the way in which the debt crisis is reducing U.S. exports. From their peak of \$2.6 billion in 1980, U.S. exports to Argentina plummeted to only \$0.7 billion in 1985. Between 1984 and 1985, U.S. exports to

Argentina fell by 20% while overall Argentine imports were declining by only 15 percent. According to the Department of Commerce, this decline is "largely explained by the recessionary effects of the austerity program reducing import demand. Imports during the January-May 1985 period actually increased 7 percent, prior to the implementation of [the most recent Argentine economic program,] the Austral program. From June to December 1985, imports plummeted 28 percent." 22/

III. FINANCIAL BARRIERS TO GROWTH

The preceding analysis suggests that by ignoring the LDC market and failing to resolve the debt crisis, administration officials had been consigning the U.S. to continued bouts of slow growth, declining exports, financially-destabilizing trade deficits, and rising unemployment. One year ago, however, Treasury Secretary James Baker unveiled a "Program for Sustained Growth." This new administration initiative was supposed to alleviate the debt crisis by funneling additional financial resources to debtor nations, thereby helping them grow more rapidly.

From one perspective, the Baker Plan represents a dramatic change in administration thinking about the debt crisis. Instead of calling on debtor nations to continue restricting their economic growth and imports, as the administration had been doing since 1982, the Baker Plan recognized that economic growth and renewed imports in Latin America would be in everyone's self-interest. With economic growth, debtor nations would be able to

resume paying interest and also halt the spiraling decline in their living standards, investment, and growth rates. Creditor countries, especially the U.S., would be able to grow more rapidly, expand their exports, and bring their merchandise trade balances under control. And last but not least, with a more certain flow of interest payments from debtor nations, the safety and soundness of the commercial banking system would be less threatened.

To accomplish these goals, Treasury Secretary Baker proposed a three-part program:^{23/}

--Debtor nations would undertake structural reforms designed to make their economies more efficient and more productive;

--The World Bank and the Inter-American Development Bank would increase their planned lending to the most heavily indebted countries by \$3 billion per year for the next three years; and

--Commercial banks would increase their planned lending by approximately \$7 billion per year for each of the next three years.

By shifting the rhetoric from austerity to growth and by calling for \$29 billion of additional financial resources to help debtor nations re-ignite their growth and presumably resume importing industrial country products, the Baker Plan represents a much overdue recognition of the way in which previous administration policies had been damaging the U.S. economy. But after four years of administration policies stressing austerity and import reductions, a rhetorical acknowledgement that damage has been done may not be enough. Thus, it is necessary to ask

whether the Baker Plan is, in fact, adequate to resolve the debt crisis, or does it only signify another dose of the same failed policies?

INCREASING THE AVAILABILITY OF FINANCIAL RESOURCES

Before the onset of the debt crisis, most of the major Latin American debtor nations were investing more than they were saving (Table 10). The gap between their rates of domestic savings and gross investment was filled by foreign savings, primarily in the form of commercial bank loans and, to a minor extent, by loans from international financial institutions such as the IMF and World Bank.

Since 1982, however, investment declined rapidly. But this decline cannot be attributed solely to a decline in domestic savings. In Argentina, Brazil, and Mexico, domestic savings as a percent of GDP actually increased, even though investment was falling. And in Chile, Columbia, Peru, and Venezuela, savings declined much less than investment.

TABLE 10
Latin America: Domestic Savings and Total Investment, 1980-1984
(Percentages of GNP)

	Domestic Savings					Investment				
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Argentina	20.8	18.4	22.4	22.4	21.6	23.0	18.9	19.0	16.2	14.7
Brazil	21.1	23.3	23.7	22.9	23.2	23.2	23.7	24.3	20.8	17.9
Chile	17.4	13.0	10.3	13.7	14.2	21.7	23.7	12.3	10.7	14.9
Colombia	19.8	17.3	16.5	17.1	18.5	19.2	20.9	20.9	19.8	19.4
Mexico	28.0	28.3	29.0	32.8	30.9	28.9	30.0	22.5	18.9	18.5
Peru	22.8	18.7	20.0	21.0	21.9	18.7	23.4	23.9	20.8	17.7
Venezuela	32.8	28.5	23.3	20.8	30.9	24.6	22.8	26.5	14.7	16.0

Source: Inter-American Development Bank, Economic and Social Progress In Latin America, 1985, Table II-1 and Table II-3.

For the major Latin American debtors, it would appear that their problem is not an inability to save but an inability to convert their domestic savings into productive investments. ^{24/} The chief culprit for this problem seems to be interest payments on the external debt and, in some countries, capital flight. With capital flight, debtor nations borrow dollars from commercial banks and then sell those dollars to citizens who use them to open bank accounts in industrial countries or to invest in industrial country stock, bond, and real estate markets. With interest payments, debtor nations borrow in order to return the funds immediately to the commercial banks in the form of debt service. But no matter what the process, both interest payments and capital flight siphon domestic savings from the region, channeling them away from growth and investment.

For example, as Table 11 illustrates, between 1981 and 1985, the net inflow of foreign capital fell from \$37.3 billion to \$4.7 billion. During that same period, the net payment of profits and interest rose by \$8 billion, from \$27.1 billion to \$35.1 billion. The net effect was a \$40 billion swing in the transfer of resources to the region. Instead of augmenting domestic savings by \$10 billion, the financial sector was draining more than \$30 billion out of the region. Since 1982, the cumulative outflow totalled \$106 billion. In only four years, that net outflow exceeded the cumulative net inflow between 1973 and 1981.

TABLE 11

<u>Year</u>	<u>Net Inflow Of Capital (1)</u>	<u>Net Payments Of Profits And Interest (2)</u>	<u>Transfer Of Resources (3) = (1) - (2)</u>
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(A)

LATIN AMERICA: NET INFLOW OF CAPITAL AND TRANSFER OF
RESOURCES, 1973-1985 (Billions of Dollars)

1973	7.9	4.2	3.7
1974	11.4	5.0	6.4
1975	14.2	5.5	8.7
1976	17.8	6.8	11.0
1977	17.1	8.2	8.9
1978	26.1	10.2	15.9
1979	29.0	13.6	15.4
1980	29.5	17.9	11.6
1981	37.3	27.1	10.2
1982	19.8	38.7	-18.9
1983	3.0	34.2	-31.2
1984	10.3	36.1	-25.8
1985	4.7	35.1	-30.4

(B)

SELECTED COUNTRIES: NET INFLOWS OF CAPITAL
AND TRANSFER OF RESOURCES, 1985

Mexico	-2.8	9.0	-11.8
Argentina	-1.6	5.5	-7.1
Brazil	-0.7	11.5	-12.2
Venezuela	-2.5	1.5	-4.0
Peru	0.4	1.2	-0.8

Source: Economic Commission for Latin America, Preliminary Overview of the Latin American Economy, 1985, December 1985, Table 13 and Table 14.

This net outflow means that a significant fraction of Latin America's domestic savings are no longer available to help finance domestic investment. And the transformation from a net inflow to a net outflow means that foreign savings that had been supplementing domestic savings and investment are now acting to hold down domestic investment, growth, and imports.

In view of these depressed levels of economic activity, it is highly unlikely that debtor nations will be able to boost their growth rates without either a significant increase in the volume of financial inflows or a reduction in the amount of interest payment outflows. As the Inter-American Development Bank explained in a recent report:

Improvement in domestic savings levels, while clearly desirable and probably a necessary part of any structural improvement, appears unlikely to be large enough--particularly in view of the depressed state of most of the economies and the relatively low income levels--to finance the needed investment in the absence of larger net external resource inflows...Interest payments will continue to absorb an amount equivalent to some two-thirds of all the growth in GDP projected for the seven countries [included in the study] in 1985-1990.... External capital inflows will have to grow at a pace not foreseeable under current market conditions, unless some mechanism is found to significantly reduce the massive outflow of interest payments.^{25/}

The Baker Plan recognizes that the debt crisis has been draining investable funds from Latin America. It tries to reduce that net outflow by calling on commercial banks and international financial institutions to increase their lending to 15 heavily-indebted countries, ten of which are in Latin America. However, relying on new lending to resolve some of the problems caused by the debt crisis raises two additional issues. First, are the amounts of new lending envisioned by the Baker Plan

sufficient to enable debtor nations to continue paying interest while restoring investment and growth to satisfactory levels? Second, can commercial banks, which the Baker Plan relies upon for the bulk of the new lending, be counted on to provide their fair share of the required new money? Unfortunately, the answer to both questions seems to be a clear no.

How much is enough? In order to rekindle economic growth, debtor nations will have to increase their investment rates substantially. And since a significant portion of Latin America's investment needs were supplied by imports, faster growth and more investment should also help to revive U.S. exports. It is no coincidence, for example, that as Latin America's investment plummeted in the wake of the debt crisis, much of the decline in U.S. exports to Latin America consisted of capital goods such as machinery and transportation equipment.^{26/}

This suggests that the key question for U.S. policymakers should not be whether debtor nations can reduce their imports by whatever amount is needed to ensure continuing interest payments. Rather, it is whether debtor nations will have the financial resources to ensure satisfactory rates of economic development, investment, and imports over the next decade.

A number of studies have tried to calculate precisely how much additional finance would be needed to rekindle Latin America's growth and import capacity. For example, in its 1986 World Development Report, the World Bank calculates that in order to pay interest on the external debt, increase imports, and revive economic growth, all developing countries--not just the

Latin American debtors--will need an annual cash infusion of approximately \$46 billion by 1990 and as much as \$74 billion by 1995. Although these amounts may seem daunting, they are considerably less than similar World Bank estimates released only one year earlier.

The IMF's projections are similar to the World Bank's. It reports that by 1991, developing country financing needs will be approximately \$51 billion.²⁷ Nearly three-fourths of the new financing will be consumed by Asian developing nations. Western Hemisphere countries, the IMF reports, will need annual cash infusions of only \$5.5 billion. And the fifteen heavily-indebted countries highlighted by the Baker Plan will actually be repaying the principal on their outstanding loans, not accepting outside financial assistance, according to the latest IMF forecast.

Both the World Bank and IMF forecasts start by estimating projected export revenues for the various groups of developing nations. Next they try to estimate interest rates, oil prices, rates of industrial country growth, and the probable volumes of official and commercial bank lending. Once these parameters are added to the model, developing country growth rates and import volumes are calculated as residuals. Put another way, these projections are "finance constrained." They are not designed to calculate how much money debtor nations will need to finance adequate rates of growth and imports. Rather, they try to calculate the rates of economic growth, investment, and imports that are financially feasible for developing nations, given their interest payment obligations and the limited amounts of financial

resources that they can realistically expect to receive.

One conclusion from these IMF and World Bank scenarios is that that the U.S. cannot realistically expect to recoup its Latin American export markets anytime soon. Since debtor nations have such large interest payment obligations, the World Bank and IMF do not believe that they can also expect to earn sufficient export revenues and receive sufficient financial inflows to finance faster growth and additional imports. However, as the IMF also reports, debtor nations would be able to grow faster and boost their imports if their financial constraints were eased.

According to an alternative IMF scenario, modest amounts of additional lending from both commercial and official sources would increase the annual rates of economic growth and imports in Western Hemisphere nations by approximately 20% to 30 percent.^{28/} Other analyses would seem to confirm the validity of this "non-finance constrained" IMF projection. For example, using the same interest rate, commodity price, and industrial country economic growth assumptions as the World Bank, the Committee For Development Finance calculates that in order to maximize their growth and imports, the fifteen Baker Plan countries would need annual infusions of \$32 billion in 1990, rising to \$66 billion per year in 1995.^{29/} For the major Latin American debtors, the Committee's estimates of annual capital requirements range as high as \$31 billion in 1990 to \$60 billion in 1995. Similarly, the Economic Commission for Latin America^{30/} notes that Latin American countries would need as much as \$25 billion in 1990, rising to \$55 billion in 1995, in order to double their current

volume of imports and restore per capita income in 1990 to its 1980 level.

If these alternative scenarios are even remotely correct, they suggest that the Baker Plan will not provide enough new funds to help debtor nations increase their imports and economic growth. Instead, virtually all of the new money will be used to pay interest. Nothing will be available to stimulate growth and imports. Consequently, with current administration policies, the damage to the U.S. economy from lost exports will not be reduced anytime soon.

Put another way, the problem with the Baker Plan is that it assumes that debtor nations will be able to boost their growth rates without purchasing additional imports or receiving additional financial assistance. In other words, it assumes that the structural reforms which debtor nations are being asked to implement are all that will be needed to fuel faster growth. While some gains can certainly be expected from increased economic efficiency, it is doubtful that these reforms can replace the \$25 to \$30 billion of additional finance that will be required by 1990 and the \$50 to \$60 billion that will be needed by 1995 to restore Latin America's import capacity.

Thus, if additional finance is, in fact, an essential prerequisite for boosting economic growth and ensuring a continuing flow of interest payments, the next question is whether the commercial banks can be counted on to provide their fair share of the new financing.

Will the banks cooperate? Trying to predict behavior is always risky. Nevertheless, judging from past behavior and considering the sums involved, it does not appear that commercial banks can be counted on to provide Latin American debtor nations with the additional funds they will need both to continue paying interest and restore economic growth, investment, and imports.

The IMF reports that as of December 31, 1981, official creditors such as the IMF, World Bank, and the U.S. Ex-Im bank held only 12.6% of Latin America's total debt.^{31/} Official creditors also held a similar proportion of the total debt of the fifteen heavily-indebted countries singled out for special attention by the Baker Plan.

Although seven-eighths of the total debt was owed to private creditors, the IMF also reports that these same private creditors contributed a disproportionately small amount of the new funds that were lent to debtor nations since the onset of the debt crisis.^{32/} For example, the proportion of new financing provided by the private sector declined from 90% in 1981--the year before the debt crisis--to 65% in 1982, and to just over 10% in 1983. In 1985, the private sector provided no new money and, in addition, reduced the value of its outstanding loans to Latin America. Consequently, official lenders provided more than 100% of the new money flowing into the region. For 1987, the IMF is also projecting a net decline in private sector financing, once again leaving official creditors with the task of providing 100% of the funds.

Judging from this record of past behavior, it would not appear likely that commercial banks will provide much of the new funds that will be needed to re-ignite growth in Latin America and restore U.S. exports to their prior levels. Nor is it certain that commercial banks can be counted on to provide even the much smaller amounts of new loans called for by the Baker Plan.

Shortly after the Baker Plan was unveiled, the administration announced that every money center bank, as well as most of the smaller banks with outstanding loans to the fifteen specified countries, had pledged to increase their lending by \$21 billion over three years, as the Baker Plan recommended. However, less than six months later, the administration was castigating the banks for refusing to honor their pledge. In mid-May, Assistant Treasury Secretary David Mulford speaking before a convention of bankers called on commercial banks to "implement their earlier pledges of support in short order....Once reforms are agreed upon [by debtor nations], commercial banks must be ready to lend without delay."³³ However, Mulford went on to note that "not enough has been done by commercial banks to assure that when the time comes, they will in fact be ready to lend."

However, if banks do not seem eager to commit even the much smaller amount of new funds called for by the Baker Plan, not to mention the much larger sums that most analyses suggest that debtor nations will need to finance economic growth, imports, and interest payments, it will be extremely difficult for the U.S. to return its international trade accounts to balance.

IV. CONCLUSION

Most analyses of the debt crisis point out correctly that rapid growth in the U.S. and other industrial countries is a precondition for resolving the debt crisis. But these same analyses never explain how the U.S. will achieve and sustain the requisite growth rates. They assume that the U.S. can boost its economic growth even though many of its best customers are mired in recession and forced to pay billions of dollars of interest every year.

Rapid U.S. growth might be possible if the debt crisis were confined to only a few inconsequential developing nations. Today, however, at least one entire continent is virtually off-limits as a source of demand. The U.S. cannot grow without markets, yet it is expected to do so anyway.

Similarly, debtor nations cannot grow rapidly when such a large portion of their domestic savings is diverted from investment to interest payments. Commercial banks, however, do not appear likely to provide the new loans needed to sustain debtor nation growth and interest payments. And money center banks are also resisting calls for debt service concessions. Consequently, it is difficult to see how debtor nations will be able either to grow their way out of debt or resume purchasing U.S. products.

For the most part, administration officials have placed primary emphasis on ensuring the uninterrupted flow of interest payments. That set of priorities has proven to be inordinately expensive for U.S. workers and exporters. And unless these

policies are reversed soon, wider segments of the economy could begin noticing the adverse consequences.

At some point, the U.S. trade deficit will disappear--irrespective of administration debt crisis policies--if for no other reason than because our industrial country trading partners will refuse to finance the U.S. deficit at affordable interest rates. When that occurs, a large and painful dollar devaluation will be required to generate the requisite growth in exports and decline in imports. Although this will increase reported U.S. growth rates, it will also entail a large decline in standards of living.

The alternative is to start reducing the trade deficit while our trading partners are still willing to finance U.S. deficits. For that to occur, however, U.S. exports will have to begin growing rapidly. Industrial countries can absorb a significant amount of additional U.S. exports. But without additional exports to developing nations in general and debtor nations in particular, it will be exceedingly difficult to reduce the U.S. trade deficit to financially-tolerable levels and still maintain U.S. standards of living.

FOOTNOTES

1. Economic Report of the President, February, 1986, Table B-1.
2. ibid., p. 39.
3. National Association of Manufacturers, U.S. Trade Balance at a Turning Point, June 1986, p. 3.
4. Statement of Paul A. Volcker before the Committee on Banking, Housing and Urban Affairs, United States Senate, July 23, 1986.
5. Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1986, p. 31.
6. U.S. Department of Commerce, Bureau of Economic Analysis, Gross National Product: Second Quarter 1986 (Revised), September 18, 1986.
7. Council of Economic Advisors, Economic Indicators, August 1986, p. 14.
8. NAM, op. cit., p. 11.
9. David C. Lund, Employment Effects of U.S. International Trade Changes (Paper prepared for workshop on "Structural Change in the U.S. Economy," on January 14, 1986). International Trade Administration, U.S. Department of Commerce.
10. Lester Davis, Contribution of U.S. Exports to U.S. Employment, Office of Trade and Investment Analysis, International Trade Administration, U.S. Department of Commerce, March 1986.
11. All merchandise trade statistics cited in this section are from Economic Report of the President, February 1986, Table B-99 and U.S. Department of Commerce, "U.S. International Transactions, First Quarter 1986," Survey of Current Business, June 1986, Table 1 and Table 3.

These sources report export and import values on a "free on board," or FOB basis. Under this reporting procedure, the value of U.S. imports includes only the value of the merchandise, as determined by U.S. Customs officials, plus the cost of transporting the goods from the factory to the port of exportation. Import values do not include the insurance and freight charges incurred in bringing the merchandise from the foreign port of exportation to the U.S.. On an FOB basis, the U.S. merchandise trade deficit was \$124.4 billion.

In a separate statistical series, FT-900 Advance Report on U.S. Merchandise Trade, the U.S. Department of Commerce reports that the 1985 merchandise trade deficit was \$148.4 billion. This deficit is calculated using cif accounting procedures which add

the cost of insurance and freight to the FOB import values. The cif trade balance is the statistic that is usually cited in news reports of the monthly trade statistics.

12. See for example, Edward M. Bernstein, "The United States as an International Debtor Country," The Brookings Review, Fall 1985. Also, U.S. Department of Commerce, "The International Investment Position of the United States in 1985," Survey of Current Business, June 1986.

13. One of the best analyses of a "hard landing" scenario can be found in Stephen Marris, Deficits and the Dollar: The World Economy at Risk, Institute for International Economics, December 1985.

14. Between 1981 and 1985, total German exports increased from \$176 billion to \$184 billion while German exports to the U.S. increased from \$11.5 billion to \$19.0 billion. During that same period, total Japanese exports increased from \$151 billion to \$177 billion. Japanese exports to the U.S., meanwhile, increased from \$38.6 billion to \$66.7 billion. All data are from International Monetary Fund, Direction of Trade Statistics Yearbook 1986.

15. Data on German and Japanese GNP are from International Monetary Fund, International Financial Statistics Yearbook 1986, series 99ac. Data on U.S. exports to Germany and Japan are from International Monetary Fund, Direction of Trade Statistics Yearbook 1986.

16. "The Impact of the Latin American Debt Crisis on the U.S. Economy," A staff study prepared for the use of the Joint Economic Committee, Congress of the United States, May 10, 1986.

17. The relative exposure of U.S. banks is reported in Department of State, Report to Congress on Foreign Debt in Latin America, December 1985.

18. All statistics in this section are from International Monetary Fund, Direction of Trade Statistics Yearbook, 1980 and 1986 editions, Western Hemisphere, Part B.

It should be noted that IMF trade statistics report that in 1985, the value of U.S. exports to Argentina was \$721 million while the value of Argentine imports from the U.S. was \$740 million. Most of this discrepancy is due to the fact that exports are recorded on an FOB basis and imports on a cif basis. Consequently, the value of U.S. exports to Argentina exclude shipping and insurance costs while those items are included in the value of Argentine imports from the U.S..

It should also be noted that the IMF reports that total U.S. exports in 1985 were \$213.1 billion while the Department of Commerce's balance of payments statistics report that U.S.

exports in 1985 were \$214.4 billion. Most of this discrepancy is due to the fact that the IMF uses census basis trade statistics, not balance of payment statistics. The difference between the two series consists primarily of technical adjustments pertaining to the valuation of certain U.S. transactions with Canada.

19. U.S. Department of Commerce, International Trade Administration, Latin America Trade Review 1985: A U.S. Perspective, March 1986, p. 3.

20. Bill Brockenborough, "The Impact on California of the Latin American Debt Crisis," Project on United States-Mexico Relations Working Paper, Stanford University. Report submitted to the Subcommittee on International Economic Policy, Committee on Foreign Relations, U.S. Senate, October 9-10, 1985.

21. Latin American Trade Review, op. cit., p. 34.

22. ibid., p. 5.

23. Statement of the Honorable James A. Baker, III, Secretary of the Treasury of the United States, Before the Joint Annual Meeting of the International Monetary Fund and the World Bank, October 8, 1985, Seoul, Korea.

24. For more detailed analyses of the link between savings, investment and interest payments on Latin America's external debt see Rudiger Dornbush, "International Debt and Economic Instability," Paper prepared for the symposium on Debts, Financial Stability, and Public Policy sponsored by the Federal Reserve Bank of Kansas City, Jackson Lake Lodge, August 27-29, 1986; Inter-American Development Bank, Economic and Social Progress in Latin America, 1985, chapter 2; Economic Commission for Latin America and the Caribbean, Economic Development: An Appraisal and Projections, 1985-1995, February 13, 1986; and Economic Commission for Latin America and the Caribbean, The Economic Crisis: Policies for Adjustment, Stabilization and Growth, April 8, 1986.

25. Inter-American Development Bank, op. cit., p. 4.

26. Latin America Trade Review, op. cit., p. 38.

27. International Monetary Fund, World Economic Outlook, April 1986, Table A54.

28. ibid., Table A56 and Table A57.

29. Committee for Development Planning, Doubling Development Finance, United Nations, 1986. The detailed econometric analysis used by the Committee for Development Planning is reported in Albert Fishlow, "Financial Requirements for Developing Countries in the Next Decade," Journal of Development Planning, forthcoming, 1986.

30. Economic Commission for Latin America, Economic Development,
op. cit.
31. IMF, World Economic Outlook, op. cit., Table A47 and
Table A48.
32. ibid., Table A41 and Table A42.
33. Statement by the Honorable David C. Mulford, Assistant
Secretary for International Affairs, U.S. Treasury Department,
before the Bankers' Association For Foreign Trade Annual Meeting,
Phoenix, Arizona, May 16, 1986.

NOTE

Page 24 Line 5 should read:

billion from 1987 to 1989 could push the increase since 1981 in the U.S.
external debt near